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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET An ocean of words, predictions and projections has flowed out of Wall Street since last May. Automobile sales records have been smashed, national income has set records and a major tax-cut bill has been prepared. But as far as the market is concerned, the "story" is anything but clear.

Industrials established a recovery peak of 726.96 in May (see Chart #1); In June Rails rose to a high of 176.19. A reaction then carried the two indicators back to lows (recorded in July) of 687.71 and 164.88 respectively.

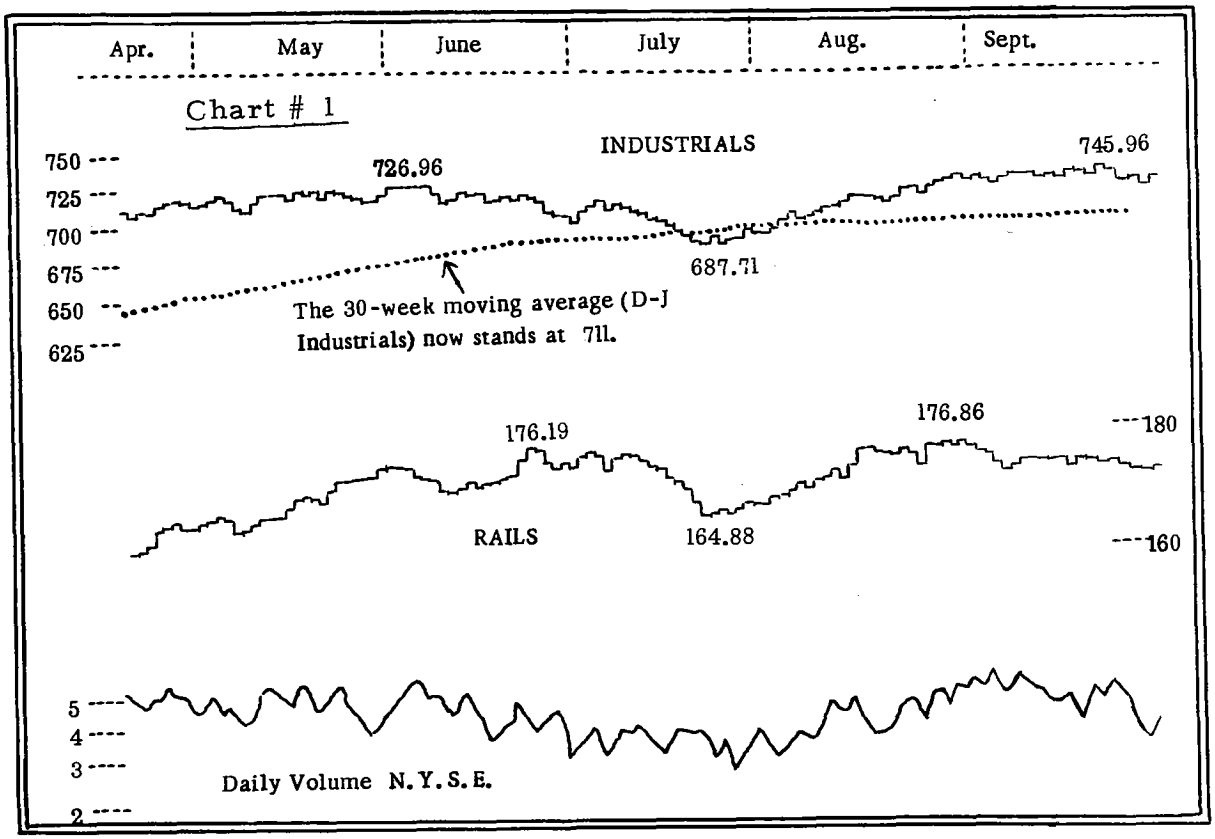
A new rally began. By late August Rails had risen to 176.86 -- exactly 67¢ above the June high. But the penetration lacked conviction and "follow-through". On September 3 the carriers turned down (diverged) in the face of a succession of new all-time highs by the senior Average.

On September 24, Industrials climbed to an historic high of 745.96; the new peak was not confirmed by Rails or the advance-decline ratio. The next day saw the beginning of a general market retreat as volume expanded to 6.3 million shares, third highest volume day of 1963. By September 30, both Averages had dropped to new lows for the month, but volume was decreasing sharply. A corrective rally began on October 1, and this rally should normally be expected to make up 1/3 to 2/3 of the losses since the highs.

Thus, during the past few weeks the Industrial Average bettered its 1961 high by 11 points, the Rail Average persistently refused to confirm -- and the A-D ratio signalled a major reversal in trend (see later section of this Letter). And the public -- did they come in or didn't they? Perhaps the wisest words on this matter were penned by Mr. Humphrey Neill in his latest Letter of Contrary Opinion (September 18): "With five to seven million shares traded daily on the N.Y.S.E., one does not require further notice that speculation is rampant and picking up followers." Later he commented: "Brokers' loans have literally leaped upward... The crowd does not necessarily have to be all 'little people'. A lot of people whose margin accounts are sizable and who buy in 100-share lots, act as a crowd." In other words, Mr. Neill believes that there has already been plenty of speculation in this market.

NOTE Because of the detailed discussion of the A-D ratio, it is again necessary to delete the chart of Buying & Selling Pressure. Selling is now at the 6,000 level and buying down to the 4,400 level. The market is "semi-oversold" by this criterion, but far from fully "oversold". The selling line has been above the buying line for 14 consecutive days (a relatively short time by past standards).

CORRECTION Letter 231, page 4 -- Late Note should have read "If we receive



240 more declines than advances", not "240 more advances than declines". I apologize. The sell signal was given on September 23.

WHAT NEXT? A fundamental and harmonious relationship normally exists between the trend of the D-J Industrial Average and the trend of the majority of stocks on the New York Stock Exchange (as represented by the A-D ratio). The Industrial Average and the A-D ratio tend to "travel together" during all market movements, be they minor, intermediate or major. Moreover, both indicators tend continually to confirm each other by bettering or violating respective preceding high or low points.

Occasionally, however, the normal harmonious relationship between the Industrial Average and the A-D ratio is interrupted by a non-confirmation or a persistent divergence (i.e., a series of two or more non-confirmations). These divergences and non-confirmations must be considered areas of abnormal action. The history of the price-breadth relationship shows that when abnormalities arise between the Industrial Average and the A-D ratio, the result is an eventual reversal of the market trend which produced the abnormality.

Further study suggests that simple non-confirmations are most apt to be associated with minor or intermediate reversals. However, the comparatively rare series of two or more non-confirmations (full divergences) are usually associated with important reactions or major bear markets.

In the case of a simple non-confirmation, the rationale is easy enough to understand. Such action means that the majority of companies (as represented by the A-D ratio) will not confirm the indications of thirty leading corporations (i.e., the Industrial Average), and a decline or correction is usually the result. Strangely enough, there have been many instances where the Industrial Average failed to confirm a new high in the A-D ratio. Such non-confirmations usually occur within bull markets, but they too can be the forerunners of declines.

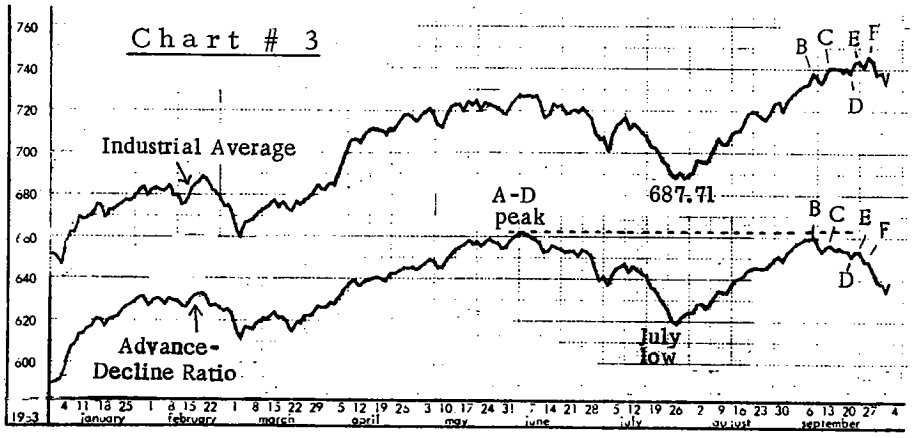
But how about the rationale for the phenonmenon of a full divergence? In my own mind, I have associated the divergence with a period in which the majority of stocks are being distributed under the guise of new peaks in the widely followed D-J Industrial Average. Furthermore, such action seems only to occur during moments of excessive enthusiasm or moments in which sufficient excitement can be generated to push the Industrial Average to two or more new highs against a steadily deteriorating general market. In these situations, we might say that the market abnormality of a non-confirmation between the Industrial Average and the A-D ratio has been compounded.

On September 23, 1963, history's twelfth full divergence between Industrials and the A-D ratio was completed. On that day Industrials retreated from their all-time peak (set the day before), while the A-D ratio dropped below point D on chart #3.

Then, on September 24, Industrials rose over 5 dollars to a fourth new peak of 745.96 (F on chart). And incredibly, on the same day the A-D ratio actually dropped fractionally to another new low. Thus, we witnessed a "quadruple divergence" between price and breadth. This writer does not remember seeing a comparable series of divergences before.

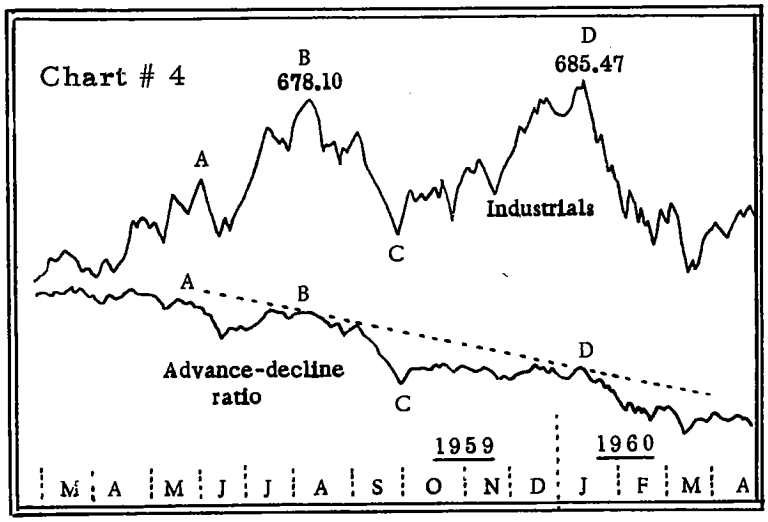
What is the meaning of the recent divergence and what can we expect ahead? Where divergences have occurred in the past, such action has signified a major "top" on the A-D ratio. From this it follows that a divergence marks a major reversal in the trend of the majority of stocks from up to down.

I have studied the action which occurred after each full divergence going back to 1919. In general, there are two types of movements which follow divergences: (1) In some cases (see case #1 below) such as September, 1929; August, 1937; March, 1962; divergence has been followed by direct collapses in both the A-D ratio and the Industrial Average. (2) But in other cases (see case #2) such as May, 1956; May, 1959; the Industrial Average refused (at least for a while) to confirm an important downside penetration by the A-D ratio. This non-confirmation produced important subsequent rallies in the Industrial Average -- rallies to or above the old highs. Eventually, however, the Industrial Average and the A-D ratio always got back "in gear" on the downside. But it was the willingness or the unwillingness of Industrials to confirm an important penetration by the A-D ratio which differentiated the long, complex tops of 1956-57 and 1959-60 from the abrupt collapses of 1929, 1937 and 1962.



Case #1... The recent 1962 action needs no great detailing; it was clear enough. A divergence was completed on March 15, 1962. The A-D ratio went into a steep decline, and by late 1962, this indicator had sunk to its lowest level since early 1954. The Industrials

confirmed by plunging through "support level" after support level. By June Industrials had broken the preceding 1960 reaction low of 566.05.



Case #2... The 1959-60 performance was much more complicated than the 1962 collapse. I have included a chart which illustrates the difficult 1959-60 series of swings. On May 26, 1959, a full divergence was completed (at point A on chart #4). During the next week the A-D ratio broke below its March-April low, but Industrials refused to confirm. A rally ensued, and on this rally Industrials climbed to an all-time high of 678.10 (B on chart).

The A-D ratio practically flattened out during the rally, and both indicators turned down again at B. At point C, the A-D ratio sank to a new low for the year -- but Industrials at C held fractionally above their June low. A remarkable new advance got underway for Industrials. By January, 1960, the senior Average had risen to a new historic high of 685.47. The performance of the A-D ratio, however, continued shockingly bad at D. On January 11, 1960, a second full divergence occurred, following which both indicators finally got in gear on the downside. By October, 1960, Industrials had broken below their lowest level of 1959 -- to a final low of 566.05.

What are the lessons to be learned? We noted (Chart #3) that a full divergence was completed on September 23. The divergence was caused by the persistent desire of the majority of issues on the N.Y.S.E. to decline -- despite a succession of new highs in the Industrial Average. In the past, such action has been associated with further major and extended declines in the A-D ratio.

Because of the lagging tendencies shown by the A-D ratio since its May, 1963, peak, and because of last week's completed divergence, the odds are now in favor of the A-D ratio's breaking below its July, 1963, low (see chart #3). The critical question then will be whether or not the Industrial Average will confirm by violating its own July low of 687.71. If Industrials confirm, the indications will be for a further important extension of the decline. But, if Industrials refuse to confirm, probabilities will then suggest (based on past history) that Industrials will rally to or above their recent high -- before a second round of trouble materializes. (I would not, however, expect the majority of issues to exhibit persistent strength in the event of such an Industrial rally).

Question: If the A-D ratio penetrates its July, 1963, low, but Industrials refuse to confirm, will you recommend that subscribers take positions in the market based on the excellent odds for a rally? Answer: If the aforementioned sequence does take place, trading positions will be recommended -- but only in the strongest stocks in the Industrial Average, on the assumption that since the Industrial Average resisted on the downside, that Average will lead the market on the rally. If or as we approach an important reversal period, I will discuss both trading positions and stocks for those positions.

STOCKS Of 432 stocks tabulated here each week, 290 or 65% are now holding above their 200-day (30-week) moving average. This is a sharp drop of 11% from last week. (Tabulations are from charts by Quote Digest, 110 North Lorraine, Wichita, Kansas).

The six stocks in the Industrial Average which now exhibit the best relative strength are Chrysler, General Motors, Goodyear, International Paper, Sears, Roebuck and U. S. Steel. This line-up may change between now and an important trading "buy-spot", and I therefore intend to keep subscribers informed in each Letter of the strongest Dow stocks.

In a situation such as this, it is easy to "jump the gun" and become hopelessly "locked in" with losses. In almost all cases of divergence between Industrials and the A-D ratio, the A-D ratio (in due time) declined below its preceding major low point (in this case the July low). I would not be tempted to do anything in the market (from the buying standpoint) until we see how the Industrial Average acts in the face of the expected decline (by the A-D ratio) under the July low.

The leading group from the standpoint of market performance (relative strength -- R.S.) continues to be the Autos. Airlines weakened noticeably over the past two weeks and the Rails have turned decidedly weaker on a trend basis. The Mining, Steel and Paper groups continue to act better than the market and we will watch them closely.

In Letter 222 I published a relative strength chart of the "sacred" Utility group, with the suggestion that these stocks be sold. The chart below shows the continued deterioration in this group's R. S. and the breaking of the four year rising channel of "popularity" (or R. S.). Most of these issues (particularly the electric utilities) are now well below their 1961 highs, and I still recommend selling the utility issues.

Sperry Rand was recommended for purchase in Letter 229. The stock has acted particularly well, and I include another (weekly) chart below. SY has broken out of a large "reverse head-and-shoulders" base, and the breakout was confirmed by both volume and the relative strength line. I would be inclined to "sweat out" Sperry through any forthcoming weakness, since the stock appears to want to go up even on market weakness. This type of action could be the forerunner of some sort of favorable news event. For those who did not buy SY, this will be one of the issues which will bear close watching through any forthcoming market weakness. If it's R. S. line continues to rise the suggestion will be that SY will be (and has been) an outstanding "buy".

Goodyear, one of the six outstanding Dow Stocks, will also be worth following carefully. Note that the stock has reversed strongly to the upside, while its R. S. line has confirmed. The acid test, in such situations, however comes during a sustained decline. If GT's R. S. line can continue to stay in a rising trend through a period of market weakness, it will be a "buy".

Two other stocks recommended in Letter 229, General Bronze and Packaging Corporation have both acted well despite market weakness. There is always a problem of what to do with strong-acting stocks when the general market turns weak. Usually, strong stocks will resist intermediate declines well, but when something like the '62 "crash" comes along -- everything goes. Because we do not know what sort of action is ahead, I would place mental "stop losses" under most stocks.

Torrington, shown below, acts very badly, has broken a "head-and-shoulders" top, and has also broken its moving average. I list it as a short candidate.

LATE MARKET NOTES: The rally of October 1 took Industrials back to within 8 points of their all-time high. It is conceivable that Industrials could go to a new high. Because the A-D ratio (and Rails) would almost surely not confirm, I would treat a new Industrial high as just another danger signal — and such a rally should be used for selling purposes.

Charts of Gen. Bronze, Torrington Co., Packaging Corp. courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas. Other charts on this page courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.